



Column: M&A transactions with government contractors

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The following is an overview of considerations to be taken into account by targets wishing to sell, and purchasers wishing to purchase, government contracting businesses.

Identification of Confidential or Classified Information

For a government contractor, due diligence is key. The government contract that may represent the crown jewel of the transaction may have significant restrictions preventing its disclosure. For example, some government contracts include provisions that cannot be disclosed to third parties because they are confidential, classified, or top secret.

Targets that wait to engage or consult counsel until their data rooms are fully populated run the risk of inadvertently posting agreements that have explicit provisions preventing such disclosure. In addition to jeopardizing a potential deal, improperly posting an agreement could lead to litigation for breach and also could jeopardize the pursuit of future contract opportunities.

Audits and Investigations

Government contracts are subject to audits relating to proposals, progress payments, incurred costs, and internal systems (such as accounting, estimating, and materials management), the objective of which is to identify and quantify flexibly-priced contract costs that are (1) prohibited under the “cost principles” set forth in Part 31 of the Federal Acquisition Regulations, (2) of insufficient benefit to be categorized as acceptable for a government contract, and (3) unreasonable as a matter of federal law.

If any of the contractor’s costs fall into one of the above categories, the contractor must either pay them, if not billed, or refund them, if billed.

Additionally, whether or not the contracts in question are fixed or flexibly priced, the auditor may

identify any failure of the contractor, if required by its business mix and volume, to comply with the Cost Accounting Standards and related disclosure statement. The auditor also may identify the contractor’s possible failure to disclose sufficiently specific cost or pricing data that are current, accurate and complete. Deficiencies identified in this area can result in the withholding of 5-10% of the contractors’ cost vouchers until corrected.

The target’s cost accounting systems, and its training and compliance policies and procedures, should be carefully scrutinized early on with the aim of identifying potential audit subjects and issues.

Any audit of a government contract could lead to an investigation if the appropriate factors are in place, so the identification of potential investigation risk is particularly important. A violation of the False Claims Act by a government contractor is the result of a knowing/willful error in pricing or billing, or reckless indifference as to their accuracy. Penalties for False Claims Act violations include treble (triple) damages and other penalties for each false claim submitted for payment or, in the case of small business representations, triple the value of the entire contract.

If a target has “credible evidence,” by way of self-investigations, hotline calls, or other employee complaints, that a False Claims Act violation exists, mitigating steps should be taken prior to marketing the target for sale.

This self-evident point is underscored by FAR 52.203-13, which, generally, requires government contractors to disclose violations of the False Claims Act or of Federal criminal law involving fraud, bribery, gratuities, or conflicts of interest connected with an award, performance, or close-out of a covered contract by a principal, employee, agent or subcontractor of the contractor.

Any due diligence investiga-

tion, either on the sell- or the buy-side, should inquire into such disclosures with the aim of proactively identifying potential audits and investigations.

Closing Conditions

Any buyer of a government contractor will want to understand the type and quantity of work performed under a target’s government contracts, the amount of backlog over the life of the contracts and what percentage of the backlog constitutes set-aside work.

This point is particularly important for sellers, who can effectively quantify and identify these issues prior to marketing the company for sale.

Additionally, the form of transaction, e.g., asset purchase or stock purchase, is particularly important in a government contracts context.

In an asset purchase, government contracts will be subject to novation, which will add time, resources and possibly uncertainty to the transaction timeline. Potential sellers may balk at these extra steps, but risk-averse buyers may not mind. Stock sales, which should not require novation of existing government contracts, tend to shift more risk onto buyers and may not be as desirable for them.

Conclusion

As a buyer or a seller, your internal due diligence program should be designed to ensure completeness and reduce the risk of deal-breaking issues arising after commencement of the purchase or sale transaction. By focusing on the process, you will be well positioned to evaluate information, navigate potential minefields, and pursue your decision to buy or sell with confidence.

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